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In the Supreme Court of the United States

OCTOBER TERM, 1945

BEULAH B. CRANE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 994

BEULAH B. CRANE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 22–32) is reported in 3 T. C. 585. The opinion of the Circuit Court of Appeals (R. 33–37) is reported in 153 F. 2d 504.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 28, 1945. (R. 38.) The petition for a writ of certiorari was filed on March 25, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer received under her husband's will an apartment house, worth about $262,000 at the time of his death and subject to a mortgage of $255,000 and accrued interest of about $7,000, so that her equity in the property was zero. For seven years she was allowed deductions for depreciation on the full value of the building without any reduction on account of the mortgage. At the end of that period the taxpayer sold the property, subject to the mortgage, for a net sum of $2,500. The question presented is the amount of taxpayer's gain, which depends upon (1) the correct cost basis of the property within the meaning of Section 113 (a) (5) of the Revenue Act of 1938 and the applicable Treasury Regulations, and (2) the amount realized upon the sale within the meaning of Section 111 (a) and (b).

STATUTES AND REGULATIONS INVOLVED

The statutes and Regulations involved may be found in the Appendix, *infra*, pp. 16–19.

STATEMENT

The parties filed a stipulation of facts which was adopted by the Tax Court as part of its findings of fact. The stipulated facts not set forth in the Tax Court's findings were expressly included by reference. The findings of the Tax Court (R. 23–26) may be summarized as follows:

The taxpayer was the sole legatee and devisee of her husband, who died on January 11, 1932, and was also the executrix of his estate. The decedent owned an apartment house, which at the time of his death was subject to a mortgage in the amount of $255,000, and on which there was due accrued interest in the amount of $7,042.50, so that the total lien on the property was $262,042.50.[1] For the purpose of the federal estate tax, the property was appraised as of the date of decedent's death at a value of $262,042.50, the exact amount due on the mortgage. (R. 23.)

On February 1, 1932, and at all times thereafter until the property was sold in November, 1938, the mortgage was in default for the nonpayment of interest. (R. 23.) In the early part of 1932 the taxpayer and the mortgagee entered into an agreement whereby the taxpayer was to operate the apartment house property, collect the rents, and pay for all necessary repairs and other expenses, reserve $200 a month for the payment of taxes, and remit the balance to the mortgagee at the end of each month on account of the mortgage. (R. 23–24.) The *net* rentals from the premises for the years 1932 to 1938, inclusive, were paid to the mortgagee by the taxpayer in accordance with the agreement. (R. 24.)

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[1] The record does not show whether the decedent personally assumed liability on the mortgage, or acquired the property subject to the mortgage.

In 1938 when the mortgagee was about to foreclose the mortgage, the taxpayer, in order to avoid such action, entered into a contract to sell the property *subject to the mortgage* for a cash consideration of $3,000. Pursuant to the contract, the taxpayer conveyed the property on November 29, 1938, and received $3,000 in cash, out of which she paid expenses in the amount of $500. The taxpayer was not a party to the mortgage, and did not at any time assume any personal liability upon the mortgage. (R. 24.)

Taxpayer filed income tax returns for the estate and for herself for the years between the death of decedent and the sale of the property, in which she reported the rentals from the apartment house as gross income, and claimed deductions for interest paid on the mortgage and for the taxes and operating expenses of the property. (R. 24–25.) She claimed deductions for depreciation each year, ranging from $3,200 to $3,900, and aggregating $25,500. (R. 2[illegible])

In her return for 1938, the taxpayer reported a capital gain of $2,500 from the sale of the apartment house property, and included one-half, or $1,250, in her income. The Commissioner determined that the taxpayer sustained a capital loss of about $500 from the sale of the land, and that she realized an ordinary gain of about $24,000 from the sale of the building. (R. 25.) The taxpayer sought a review of the Commissioner's determination in the Tax Court, which decided that

the basis of the property was zero and that the gain was limited to $2,500, which represented the total "amount realized." The Commissioner appealed to the Circuit Court of Appeals, which reversed the decision of the Tax Court, with Judge Swan dissenting.

ARGUMENT

1. This is the first case in which the precise question involved has arisen, and there is therefore no possibility of a conflict of decisions. Moreover, the decision of the court below is correct and is in harmony with the uniform practice of long standing of the Treasury Department.

The principal question is the amount of gain realized by the taxpayer on the sale of property acquired by bequest subject to a mortgage and sold by the taxpayer subject to the mortgage. In order to determine the amount of gain realized on the sale of the property in question, it is necessary first to determine the cost basis of the property within the meaning of Section 113 (a) (5) of the Revenue Act of 1938 (Appendix, *infra*) and the applicable Treasury Regulations, and secondly, the amount realized from the sale of the property within the meaning of Section 111 (a) and (b) of the Revenue Act of 1938 (Appendix, *infra*).

Section 113 (a) (5) provides in part that the basis of property acquired by bequest, devise or inheritance shall be the fair market value of such property at the time of such acquisition. Article

113 (a) (5)–1 of Treasury Regulations 101 (Appendix, *infra*) provides in subdivision (b) (1) that the time of the acquisition of such property is the death of the decedent, and in subdivision (c), that for the purposes of this article, the value of the property as of the date of the death of the decedent as appraised for the purpose of the federal estate tax shall be deemed to be its fair market value at the time of the death of the decedent. This provision of the Treasury Regulations has been in effect since 1918,[2] and the corresponding statutory provision has been reenacted in substantially the same form in all succeeding Revenue Acts.[3] There can be no doubt that for estate tax purposes Congress intended that the reported value of the

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[2] See Treasury Regulations 45, Art. 1562; Treasury Regulations 62, Art. 1563; Treasury Regulations 65, Art. 1594; Treasury Regulations 69, Art. 1594; Treasury Regulations 74, Art. 596; Treasury Regulations 77, Art. 596; Treasury Regulations 86, Art. 113 (a) (5)–1 (c); Treasury Regulations 94, Art. 113 (a) (5)–1 (c); Treasury Regulations 101, Art. 113 (a) (5)–1 (c); Treasury Regulations 103, Sec. 19.113 (a) (5)–1 (c); Treasury Regulations 111, Sec. 29.113 (a) (5)–1 (c).

[3] Sec. 202 (a) (3) of the Revenue Act of 1921, c. 136, 42 Stat. 227; Sec. 204 (a) (5) of the Revenue Act of 1924, c. 234, 43 Stat. 253; Sec. 204 (a) (5) of the Revenue Act of 1926, c. 27, 44 Stat. 9; Sec. 113 (a) (5) of the Revenue Act of 1928, c. 852, 45 Stat. 791; Sec. 113 (a) (5) of the Revenue Act of 1932, c. 209, 47 Stat. 169; Sec. 113 (a) (5) of the Revenue Act of 1934, c. 277, 48 Stat. 680; Sec. 113 (a) (5) of the Revenue Act of 1936, c. 690, 49 Stat. 1648; Sec. 113 (a) (5) of the Revenue Act of 1938, c. 289, 52 Stat. 447; Sec. 113 (a) (5) of the Internal Revenue Code, as amended by Sec. 144 of the Revenue Act of 1942, c. 619, 56 Stat. 798.

property in the gross estate should not be reduced by a mortgage; the amount of the mortgage is included in the deductions employed in computing the net estate. See H. Rep. No. 708, 72d Cong., 1st Sess., p. 48 (1939–1 Cum. Bull. (Part 2) 457, 491), and S. Rep. No. 665, 72d Cong., 1st Sess., p. 51 (1939–1 Cum. Bull. (Part 2) 496, 533), explaining Section 805 of the Revenue Act of 1932, which amended Section 303 (a) of the Revenue Act of 1926.

Applying the regulation to the facts of this case, the Tax Court said (R. 29):

> There is no dispute here as to the fair market value of the apartment house property at the basic date. That value is $262,042.50, which was used for estate tax purposes.

While the precise question involved in this case relates to the amount of *gain* realized on property, subject to a mortgage, acquired by the taxpayer by bequest and sold by the taxpayer subject to the mortgage, the case necessarily involves the question of *depreciation* on property acquired by bequest and subject to a mortgage, because Section 114 of the Revenue Act of 1938 (Appendix, *infra*) provides that the basis for depreciation shall be the same as the basis for gain or

[1] However, the Tax Court erroneously substituted for this figure the value of the taxpayer's interest in the property. (R. 29.) This defeats the statutory purpose to protect the revenue by requiring the devisee to use as a basis the same value which was reported for estate tax purposes. Section 113 (a) (5) of the 1938 Act (Appendix, *infra*). Compare *Maguire* v. *Commissioner*, 313 U. S. 1, 10.

loss.[5] Indeed, in this case the taxpayer claimed, and was allowed, deductions for depreciation based on the full value of the building on the date of the death of the devisee without any deduction on account of the mortgage. The deductions aggregated $25,500, which approximates the amount of gain determined by the Commissioner. (R. 25.) Moreover, as the court below pointed out in its opinion, to treat the devisee's equity as the basis for depreciation would require repeated recomputations,[6] if the devisee pays off the mort-

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[5] It was because this case threatened the long continued policy of the Treasury Department with respect to depreciation of property acquired by bequest and subject to a mortgage that some of the federal tax services adversely criticized the opinion of the Tax Court in this case. 1944 P-H, par. 60,512; 1944 C. C. H., pars. 8843–8850, inclusive.

[6] Assume, for example, that a taxpayer inherits business property with a fair market value of $90,000, subject to an unassumed mortgage of $40,000, leaving as his equity $50,000; that he depreciates the property on a straight line basis on an estimated life of 20 years; and that he makes an annual $2,000 payment on mortgage principal. In the first year the depreciation on the equity is $2,500. For each successive year the basis will have to be adjusted to reflect the principal payments on the mortgage, and depreciation for previous years will have to be substracted from the adjusted basis to determine the amount of depreciation allowable for the next succeeding year. Thus for the second year the depreciation will be [($50,000 plus $2,000)—$2,500] divided by 19, or a result of $2,505.26; for the third year $2,716.37; and for the fourth year $2,834.02. The depreciation allowances will increase progressively as the property's estimated life decreases; the nineteenth mortgage principal payment of $2,000 will be entirely depreciated within the twentieth year; and

gage in installments and would introduce administrative complication and confusion. (R. 35.) The court below said in its opinion (R. 35):

> We cannot doubt, especially in view of the long uniform practice, that the right "basis" for depreciation is the actual value of the buildings.

Having determined the unadjusted basis of the property, it is then necessary under Section 111 (a) to determine the adjusted basis under Section 113 (b) (Appendix, *infra*), which provides for the reduction of the basis by the amount of depreciation allowed, but not less than the amount allowable. This Court decided that it was necessary to adjust the cost basis on account

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the property's estimated life will have expired before the twentieth payment of $2,000 on mortgage principal can be depreciated.

Moreover, if taxpayer fails to amortize the mortgage for a number of years and then under pressure of threatened foreclosure makes a substantial payment in one year, the consequence will be to compress a large allowance for depreciation within a relatively short period. Should the taxpayer in the above illustration make no payments on the mortgage until the sixteenth year and then reduce the mortgage by $30,000, he will be entitled, under the rule of the instant case, to depreciate the $30,000 capital outlay in the remaining five-year life of the property, together with the remaining five years' depreciation of his original equity interest.

Another result might be to set up a minus basis for the property in those cases where the amount of the mortgage exceeds the fair market value of the property on the critical date (the date of the decedent's death).

of accrued depreciation in order correctly to determine the amount of gain or loss. *United States* v. *Ludey*, 274 U. S. 295.[1] Since there is no dispute as to the value of the apartment house on the date of the devisor's death and no controversy about the rate of depreciation, namely, two percent, the adjustment on account of depreciation is a mere matter of simple computation.

As to the second factor, in determining gain or loss, the "amount realized" from the sale of property is the sum of any money received plus the fair market value of the property (other than money) received. Section 111 (b) of the Revenue Act of 1938. While the taxpayer did not assume liability on the mortgage, she held the property subject to the mortgage and was obliged to pay interest on the mortgage as long as she held the property. Unless she also paid the installments of principal as they fell due, she stood to lose the property upon foreclosure and to forfeit whatever income might be derived from it. She assumed these burdens in accepting the devise; and she recognized that fact when she made arrangements with the mortgagee to pay it the net income from the property instead of paying interest and installments of principal.

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[1] This Court has also decided that the cost basis must be adjusted on account of depreciation even though the taxpayer does not receive a tax benefit from unclaimed allowance for depreciation. *Virginian Hotel Co.* v. *Helvering*, 319 U. S. 523.

The Tax Court found that in the income tax returns for the period during which she held the property she claimed deductions for interest paid on the mortgage. This was in accordance with Treasury Regulations of long standing* which treated her as though she were directly liable on the mortgage, and as though the mortgage debt were her debt.

She was relieved of these obligations when she sold the property, subject to the mortgage, and thus the cash alone is not the full measure of the consideration she received. In the absence of any evidence to the contrary as to the value of these benefits, it would seem reasonable to value them in the amount of the principal of the mortgage, because that figure represents the capitalized value of her obligation to pay interest and the aggregate of the installments of principal.

Furthermore, it would be unreasonable to include the amount of the mortgage for the purpose of determining the *basis*, as required by the application of the regulation to the facts of this case, and then to exclude the amount of the mortgage in ascertaining the *amount realized*. In

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* See Treasury Regulations 45, Art. 121; Treasury Regulations 62, Art. 121; Treasury Regulations 65, Art. 121; Treasury Regulations 69, Art. 121; Treasury Regulations 74, Art. 141; Treasury Regulations 77, Art. 141; Treasury Regulations 86, Art. 23 (b)-1; Treasury Regulations 94, Art. 23 (b)-1; Treasury Regulations 101, Art. 23 (b)-1; Treasury Regulations 103, Sec. 19.23 (b)-1; Treasury Regulations 111, Sec. 29.23 (b)-1.

this case, such inconsistency would permit the taxpayer to show a loss of more than $175,000 on the building, when she admittedly realized some gain. Under the regulation her unadjusted basis for the entire property (land and building) was about $262,000, as shown above; and when this figure is adjusted on account of depreciation allowable during the period she held the property, the adjusted basis of the building is about $178,000. (R. 25.) If the amount of the mortgage is excluded in computing the amount realized, the taxpayer received only the cash payment of $2,500. The excess of the adjusted basis of about $178,000 over the amount realized, $2,500, would result in a loss of about $175,000.

It may be pointed out that if the principal amount of the mortgage is not included in the amount realized, it would seem to follow that the purchaser from the taxpayer has a cost basis of only $2,500 for the property, and that this is contrary to the generally prevailing accounting practice. See II Kester, Accounting Theory and Practice (2d ed., 1925) 383; also 1944 P-H, par. 60,512.

The Tax Court refused to include the amount of the mortgage in the amount realized because the taxpayer had not assumed liability on the mortgage. Ever since 1926[9] the Treasury Regulations relat-

[9] See Treasury Regulations 69, Art. 44; Treasury Regulations 74, Art. 352; Treasury Regulations 77, Art. 352; Treas-

ing to installment sales have provided that in the sale of mortgaged real estate the amount of the mortgage shall be included as a part of the selling price, *whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser.* By analogy, it should not make any material difference in this case whether the taxpayer assumed the mortgage or took the property subject to the mortgage. See also Section 213 (d) of the Revenue Act of 1939, c. 247, 53 Stat. 862, amending Section 113 (a) (6) of the Internal Revenue Code, where Congress has treated the acquisition of property subject to a liability in the same manner that it treats the assumption of a liability, for basis purposes. This policy would appear to be sound because mortgage holders of commercial property ordinarily look to the land as security and not to the financial standing of the mortgagor.

A choice must be made between two alternatives: (1) An allowance of depreciation on the full value of the property, with a consequent inclusion of the mortgage as a common element of cost and amount realized, or (2) an exclusion of the mortgage as such an element, with a consequent reduction of the depreciation allowance. Pursuant to a long standing administrative practice, the Com-

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ury Regulations 86, Art. 44-2; Treasury Regulations 94, Art. 44-2; Treasury Regulations 101, Art. 44-2; Treasury Regulations 103, Sec. 19.44-2; Treasury Regulations 111, Sec. 29.44-2.

missioner chose the first course. The Tax Court preferred the second alternative, on the theory that a distinction should be drawn between a taxpayer who is liable on a mortgage and a taxpayer who assumes a mortgage.[10] While such distinctions have been drawn under circumstances foreign to the situation disclosed here, none of the cases upon which taxpayer relies has involved the problem of the need for correlating the basis for depreciation with the computation of gain or loss upon sale. We think Congress clearly intended that the mortgage be included in the basis for depreciation and that respect for the obvious symmetry of the statutory scheme compels the conclusion that it be also included in the amount realized.

2. The taxpayer also assigns as a reason for granting the writ the contention that it would violate the Sixteenth Amendment to impose a tax on the basis of a gain of about $24,000. This argument assumes, contrary to *United States* v. *Ludey*, 274 U. S. 295, that taxpayer sold precisely the same property acquired by bequest. The truth is that the property had depreciated to the extent of more than $24,000.

3. The taxpayer alleges in her petition that the decision of the court below is in conflict with the decisions of this Court in *John Kelley*

[10] In a later opinion the Tax Court has qualified its distinction. *Hilpert* v. *Commissioner*, 4 T. C. 473, reversed, 151 F. 2d 929 (C. C. A. 5th).

Co. v. *Commissioner,* decided January 7, 1946, not yet reported, and *Dobson* v. *Commissioner,* 320 U. S. 489. The critical question in this case is whether in determining the "amount realized" upon the sale of property a distinction should properly be made between a taxpayer who is personally liable on the mortgage and one who is not, although the amount of the mortgage must be included in the basis of the property in accordance with the terms of a Treasury regulation. We submit that this presents a clear-cut question of law which is reviewable. See *Commissioner* v. *Wilcox,* decided by this Court on February 25, 1946, not yet reported.

CONCLUSION

There is no conflict of decisions and the decision of the court below is correct. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APRIL, 1946.

APPENDIX

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * *

(5) *Property transmitted at death.*—If the property was acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, the basis shall be the fair market value of such property at the time of such acquisition. * * *

* * * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the

sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws, * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

Treasury Regulations 101, relating to the Revenue Act of 1938:

ART. 113 (a) (5)–1. *Basis of property acquired by bequest, devise, or inheritance.*—* * *

(b) * * *

(1) *General rule.*—Except as prescribed in paragraph (2) the basis of property acquired from a decedent by will or under the law governing the descent and distribution of the property of decedents is the fair market value at the time of such acquisition. Since under the law governing wills

and the distribution of the property of decedents, all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of him who takes the title was, at the date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise, the time of the acquisition of such property is the death of the decedent. * * *

The purpose of the Act, in prescribing a general uniform basis rule for property acquired by bequest, devise, or inheritance, is, on the one hand, to tax the gain, in respect of such property, to him who realizes it (without regard to the circumstance that at the death of the decedent it may have been quite uncertain whether the taxpayer would take or gain anything); and, on the other hand, not to recognize as gain any element of value solely from the circumstance that the possession or enjoyment of the taxpayer was postponed. Such postponement may be, for example, until the administration of the decedent's estate is completed, until the period of the possession or enjoyment of another has terminated, or until an uncertain event has happened. It is the increase or decrease in the value of property reflected in a sale or other disposition which section 113 (a) (5) recognizes as the measure of gain or loss.

* * * * *

(c) *Fair market value.*—For the purposes of this article, the value of property as of the date of the death of the decedent as appraised for the purpose of the Federal estate tax or if the property is not appraised as of the date of death of the de-

cedent for such purpose or if the estate is not subject to such tax, its value as appraised as of the date of the death of the decedent for the purpose of State inheritance or transmission taxes, shall be deemed to be its fair market value at the time of the death of the decedent.

* * * * *

(e) *Adjustments to basis.*—In the hands of every person who acquires the property of a decedent (or any estate or interest therein) by bequest, or devise, or inheritance, the basis of the property is always the same,

(1) whether such person be the executor or administrator, the heir, the legatee, the devisee, the trustee of a trust created by the will, or any beneficiary of such trust, and whatever the nature of any such person's interest or estate may be;

(2) whether during or after administration and settlement of the estate of the decedent, during or after the term of any trust under the will, or before or after the distribution by the executor or administrator, or the trustee.

Adjustments to basis required by section 113 (b) are made in accordance with the same principles. * * *

* * * * * *

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